Mr William Potts
Base Erosion and Profit Shifting Unit
Corporate Income Tax Division
Revenue Group
The Treasury
Langton Crescent
PARKES ACT 2600

4 April 2018

By email: william.potts@treasury.gov.au

Dear William,

OECD Hybrid Mismatch and Integrity Rules

PricewaterhouseCoopers (**PwC**) welcomes the opportunity to make a submission to Treasury in relation to the Exposure Draft (**ED**) legislation and accompanying Explanatory Memorandum (**EM**) *(Treasury Laws Amendment (OECD Hybrid Mismatch Rules) Bill 2018)* to implement the OECD hybrid mismatch rules, branch hybrid mismatch rules and a new "integrity rule" released for comment on 7 March 2018.

Given the complexity of the provisions and limited timeframe, the intention of our submission is not to cover detailed technical points but rather to highlight several key issues. We note that we have already discussed a wide range of technical issues relating to the drafting of the provisions with you and your team at Treasury over the past four weeks.

PwC makes the following general submissions.

1. **Rules are complex and uncertain in a number of areas**

   The rules are extremely complex and require a solid understanding of foreign tax systems. Identifying potential hybrid mismatches is not always straightforward and the exercise will become even more complex as other countries progressively introduce hybrid legislation which may (or may not) align with the OECD recommendations. This complexity has become more evident as we have been road testing the ED with clients operating globally.

   There are a number of unanswered questions and technical issues identified with the drafting which we have highlighted to you in our various discussions. In this regard, we have requested that the ED explain whether it is intended that the interpretation of the legislation should be informed by the OECD report(s) in relation to hybrid mismatches. The draft law explains that Division 832 is "based on" the OECD Action 2 Report of 5 October 2015 and, for example, the EM refers to rules that

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"effectively implement" or are "consistent with" a particular recommendation of the OECD Action 2 Report or OECD Branch Mismatch Arrangements Report.

There are also numerous issues relating to the interaction of proposed Division 832 with existing tax rules that have not been addressed. For example, we have requested that the FITO rules be amended to ensure that a tax offset will be available in respect of disregarded transactions that are subject to a forced inclusion in assessable income; in Example 1.14 of the EM, ABC Ltd should be entitled to a tax offset for interest withholding tax imposed by Country B (there is some doubt about this under general rules because of the single entity rule which "disregards" the interest payment).

2. Restructuring satisfying the objective of hybrid mismatch rules

The draft EM recognises that *"… many taxpayers will restructure out of hybrid arrangements and enter into alternative arrangements that do not attract the operation of the hybrid mismatch rules"*. In addition, it states that a restructure that, for example, *"...could result in retaining a deduction [in Australia] with a greater amount being included in a foreign income tax base...would satisfy the objective of the hybrid mismatch rules"*.

These comments reflect our submission of 22 December 2017 and are welcome. However, PwC are of the strong view that these comments should be expanded to recognise that:

- a deduction may be retained without <u>any</u> (cf. "greater") amount being included in a foreign tax base;
- restructuring may involve retaining an <u>exemption</u> (cf. retaining a deduction) in Australia; and
- restructuring to comply with the "integrity rule" would satisfy the objective of the hybrid mismatch rules (viz the Australian version which includes a unilateral "FIZLR" rule, as discussed below).

In addition, the EM should state explicitly that any restructure which satisfies the objectives of the hybrid mismatch rules would not be expected to be affected by Australia's anti-avoidance provisions.

3. Operative date needs to be clarified

Based on our experience to date, in almost all cases, simply allowing the hybrid mismatch rules to apply to existing arrangements will not be a viable option for various reasons (e.g. the risk of withholding tax on non-deductible interest, impact on thin capitalisation and transfer pricing). Therefore, Australian taxpayers with hybrid mismatches will need to restructure and enter into alternative arrangements that do not attract the operation of the hybrid mismatch rules. This will require careful consideration of regulatory, banking, legal, financial, accounting, treasury and foreign tax issues and timing will be tight given the wide range of complexities involved.

The interests of fairness require that the new law (in its <u>final form</u>) should be available well in advance of the proposed application date.

For these reasons, PwC strongly recommends the Government apply the hybrid mismatch rules from the **<u>later of</u>** 1 January 2019 or six months after the law receives Royal Assent (to the extent the latter option prevails, we further recommend that the rules apply from the first day of the relevant half year - 1 January or 1 July).

In accordance with the approach being adopted by New Zealand, we recommend that the commencement date for “unstructured” imported mismatches be delayed until 1 January 2020.

4. The “Integrity Rule” is inconsistent with OECD recommendations

Australia’s endeavour to enact a minimum headline tax rate of 10.01% on certain income of non-residents is inconsistent with the OECD Action 2 Report which states that *“The recommendations in the report with respect to D/NI arrangements are not intended to capture payments made to a person resident in a no-tax jurisdiction”.* PwC is disappointed with this departure from Australia’s commitment to a consensus based approach in accordance with the BEPS project.

We have highlighted a wide range of practical difficulties associated with a unilateral rule that seeks to define Foreign Interposed Zero or Low Rate (**FIZLR**) entities. We have also questioned the logic of this rule given that most, if not all, payments to a potential FIZLR entity will have been subject to 10% Australian (interest withholding) tax.

5. Impact of US tax reform

The United States (**US**) recently enacted the most comprehensive tax reform in more than 30 years including a reduction in the Federal corporate tax rate from 35% to 21% and wholesale changes to the international tax rules including hybrid mismatch, Foreign Derived Intangible Income and Global Intangible Low Taxed Income (**GILTI**) rules. We have highlighted a number of practical examples where US tax reform may create uncertainty in relation to the hybrid mismatch rules including, for example, the likelihood that GILTI is a “corresponding provision” of a law of the US and should generate more income that is “subject to foreign [US] tax” for the purposes of the dual inclusion income rules. However, PwC is concerned that there has been inadequate time to address the likely impact of US tax reform on Australian investment and trade including the impact on the proposed hybrid mismatch rules.

6. Funds and foreign banks are adversely impacted

The proposed hybrid mismatch rules gives rise to a wide range of important issues for funds and foreign banks. Whilst our subject matter experts have separately discussed our comments in each of these areas with you and your team, one issue worth highlighting again is the broad operation of the deducting hybrid mismatch rule.

The deducting hybrid mismatch rule is very broad and could capture a variety of outbound flow through structures, even where the entities involved are not “hybrid” in their nature (e.g. limited partnerships that are treated as partnerships in Australia and the foreign tax jurisdiction). These rules are likely to particularly penalise the superannuation and funds management industry where it is common industry practice to invest offshore through flow through structures. It is also likely to be administratively extremely challenging to gather relevant underlying information to identify double deductions associated with deducting hybrids, particularly where investments are made in fund of fund structures.

PwC recommends that this rule is re-drafted to limit the breadth of its application.

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We look forward to the opportunity of discussing our submission with you in further detail. In the interim, if you have any questions please contact us.

Your sincerely,

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